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Tax Tips for Leasing of Tangible Personal Property In California

Sales and Use Taxes

January 1994

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PREFACE

This pamphlet is designed as a general guide for both lessors and lessees in California and provides basic information on the application of California Sales and Use Tax Laws to leasing of tangible personal property.

If you cannot find the information you are looking for in this booklet, please contact your local Board office. Staff will be glad to answer your questions. Telephone numbers of Board offices are listed on page 16.

This pamphlet complements another Board of Equalization publication, Pamphlet 73, *Your California Seller's Permit*. That publication, which is provided to first-time applicants for seller's permits, includes general information about obtaining a permit; using a resale certificate; collecting and reporting sales and use taxes; buying, selling, or discontinuing a business; and keeping records. If you do not already have a copy of this booklet, you may request one from your local Board office.

We welcome your suggestions for improving this or any other tax tip pamphlet. Please send your suggestions to:

Audit Evaluation and Planning Section
State Board of Equalization
P.O. Box 942879
Sacramento, CA 94279-0001

NOTE: This pamphlet summarizes the law and applicable regulations in effect when the pamphlet was written, as noted on the cover. However, changes in the law or in regulations may have occurred since that time. If there is a conflict between the text in this pamphlet and the law, the latter is controlling.

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LEASES — AN OVERVIEW

WHAT IS A LEASE?

In general, a lease is a temporary transfer of the possession of tangible personal property for consideration. The term “lease” includes rental, hire, and license. It does not include a use of tangible personal property for a period of less than one day for a charge of less than twenty dollars (\$20) when the privilege to use the property is restricted to use on the premises or at a business location of the grantor of the privilege.

The definition of a lease in the California Sales and Use Tax Law is singular to that law. It is distinct in its application and may in certain instances differ from income tax treatments by the United States and the State of California, property tax laws of the state, and recommended treatment by the American Institute of Certified Public Accountants and other professional groups and regulatory bodies. Certain leases are defined by the Sales and Use Tax Law as continuing “sales” and “purchases.” This is an important factor in determining how the tax applies.

SALES OR USE TAX MAY APPLY

The sales tax is imposed upon retailers for the privilege of selling tangible personal property at retail in California. Whether or not the retailer is reimbursed by the customer for sales tax depends solely on the terms of the agreement of sale between the buyer and seller. It will be presumed that the parties agreed to the addition of sales tax reimbursement to the sales price if sales tax is shown on the sales check or other proof of sale. It is the retailer whom the law holds responsible for the tax.

The use tax complements the sales tax and is imposed upon consumers in California. It is an excise tax imposed on the “storage, use, or other consumption,” referred to as “use,” of tangible personal property in California purchased from any retailer. The use tax generally applies to the use of property purchased from retailers outside of California, or purchased from retailers in California to whom the purchaser has issued a resale certificate or purchased from retailers, such as insurance companies, which are exempt from imposition of the sales tax. The use tax also applies to purchases of vehicles, vessels, and aircraft from sellers who are not engaged in the business of selling such property.

Generally, in lease transactions the tax imposed is a **use tax** on the lessee measured by rentals payable. This is true when the lease is one that is considered a continuing “sale” and “purchase.” If the lessee is exempt from the use tax, as in the case of insurance companies, the tax imposed is the **sales tax** which is imposed upon the lessor.

HOW TAX APPLIES TO LEASES

There are three basic ways that the tax applies to leases, depending on the type of property being leased, the means by which a lessor obtained the property, and the contract between the lessor and lessee. Some leases are taxed based on the cost of the property being leased, some are taxed based on the rental receipts, and some leases are taxed based on the fair rental value of the property being leased.

Leases Taxed Based on the Cost of the Property to the Lessor. The tangible personal property being leased must be in substantially the same form as acquired and the lessor must elect to either pay tax to the vendor when the property is purchased or pay use tax to the state for the period in which the property is first leased. This type of lease is not a continuing “sale” and “purchase.”

Leases Taxed Based on Rental Receipts. If no tax is paid by the lessor on the purchase price of the tangible personal property being leased, or if the property is not leased in substantially the same form as acquired, the lease is generally considered a continuing “sale” and “purchase,” and tax is required to be reported and paid based on rental receipts. The lessor is required to collect tax on the rental receipts and report the amount collected in the period in which the rental receipts were received. The taxable amount of the rental receipts includes license fees, royalties, reproduction rights, advance rental payments, interest charges, property taxes, deficiency charges, and mandatory charges for items such as maintenance and warranties.

Leases Taxed Based on Fair Rental Value. Leases of some items of tangible personal property, such as mobile transportation equipment, may be taxable based on the fair rental value of the property leased, provided the equipment was purchased without tax. (See “Lessor’s Elections and Obligations.”) Fair rental value is **ordinarily** regarded as the amount received from lessees but does not include any payment made by the lessee to reimburse the lessor for the lessor’s use tax, whether or not the amount is separately stated, and regardless of how the charge is designated in the lease documentation and invoices. Lump sum charges to the lessee will be assumed to include reimbursement for the lessor’s use tax whether or not any statement to that effect is made to the lessee. In these circumstances, a lessor is required to report the fair rental value of property leased during each reporting period whether or not the rental payments have been received. This type of lease is **not** a continuing “sale” and “purchase.”

OBLIGATIONS OF THE LESSOR AND THE LESSEE

THE LESSOR

Pays Tax Based on Purchase Price. Leases of the following categories of items are not considered to be continuing “sales” and “purchases.” The lessor must pay sales tax or report use tax on the purchase price of the following items when purchased for leasing purposes:

- Motion pictures or animated motion pictures, whether or not they are productions complete in themselves. This includes television, films, and tapes. This does **not** include leases of video cassettes, videotapes, and videodiscs for private use under which the lessee or renter does not obtain or acquire the right to license, broadcast, exhibit, or reproduce the cassette, tape or disc.
- Household furnishings with a lease of the living quarters in which they are to be used. The lessor of the household furnishings must also be the lessor of the living quarters. The living quarters must be real property rather than tangible personal property.
- Linen supplies and similar articles including such items as towels, uniforms, coveralls, shopcoats, dust cloths, etc., when an essential part of the lease is the furnishing of the recurring service of laundering or cleaning of the articles leased.
- Items used:
 - on the premises of the lessor (grantor of privilege);
 - for less than one day;
 - for less than \$20.00.

All of the preceding criteria must be met. Examples of such businesses include laundromats, self-service dry cleaning establishments, and horseback riding stables where horses are restricted to the area owned or leased by the grantor of the privilege.

- Mobile transportation equipment for use in transportation of persons or property unless the lessors take a **timely** election to pay their tax liability based on “fair rental value.” See “Mobile Transportation Equipment Leases.”
- Videotapes, video cassettes and videodiscs leased or rented for commercial purposes. See Regulation 1660 (d) (2), for specific application.
- Mobilehomes originally sold new after June 30, 1980. Pamphlet No. 47, “Mobilehomes and Factory-Built Housing,” may be obtained from any Board of Equalization office.

Collects Use Tax on Lease Receipts. The lessor must collect use tax from lessees on lease receipts in the following instances, which are considered to be continuing “sales” and “purchases.”

- If the property is not leased in substantially the same form as acquired. Following are circumstances under which the property is deemed **not** to have been leased in substantially the same form as acquired:
 - fabrication of components into a serviceable or functioning unit or system after acquisition by the lessor;
 - functional capabilities, characteristics, or form have been significantly changed following acquisition;
 - a relatively significant amount of fabrication labor has been performed on the acquired property;
 - an appreciable change in value accompanied by a change in configuration of functional capabilities has occurred after purchase.
- Chemical toilets — Rental receipts from rentals of chemical toilets are subject to tax. If a cleaning service is provided at the **option of the lessee**, a separately stated charge for that service would not be included in rental receipts subject to tax.
- Videotapes, video cassettes and videodiscs when leased or rented for private noncommercial purposes. See Regulation 1660, for specific application.

Pays Tax Based on Fair Rental Value. When lessors rent mobile transportation equipment, they have the option of reporting their tax liability based on “fair rental value.” “Fair rental value” normally refers to the rental payments that are required by the lease, whether or not those payments have actually been received. Fair rental value does not include any payment made by the lessee to reimburse the lessor for the lessor’s use tax, whether or not the amount is separately stated. Lump-sum charges to the lessee will be assumed to include reimbursement for the lessor’s use tax whether or not any statement to that effect is made to the lessee. See page 6 for a more detailed discussion of leases of mobile transportation equipment.

Has an Option. Lessors have the option either to collect use tax from lessees on lease receipts, pay tax to the vendor at the time of the purchase of the property, or timely pay use tax on the purchase price of the property leased in the following circumstances:

- Property (other than one-way truck rentals) leased in substantially the same form as acquired.
- One-Way Truck Rentals, defined as motor trucks required to be registered under the Vehicle Code, not exceeding the manufacturer’s gross vehicle weight rating of 24,000 pounds, which are principally employed by a person in the rental business and leased out for short-term periods of not more than 31 days to individual customers for one-way or local hauling.
- Mobilehomes originally sold new prior to July 1, 1980 and not subject to local property taxation.

When property is leased in substantially the same form as acquired, and the lessor wishes to pay tax to the vendor or pay use tax based on the purchase price, the lessor must pay tax to the vendor or pay use tax in a payment to the state timely for the period when the item is first leased. If the lessor fails to pay the tax in this fashion, the lessor must thereafter collect use tax measured by rental receipts from the lessee.

With respect to one-way truck rentals, the lessor must report tax measured by the rental receipts on the return for the period in which the truck is first put into rental service in order for the truck to be designated as a one-way rental truck and thereafter allow the lessor to report tax measured by the rental receipts. If this election is not made timely, the truck will be treated as mobile transportation equipment and tax will be due based on the purchase price of the truck.

Timely Election. It should be stressed that in order for lessors to utilize the foregoing options to determine the measure of tax, they must make their election timely. Generally, a timely election means that the election must be made on the return for the reporting period in which the leased equipment first enters lease service. Clerical oversight is **not** an acceptable excuse for not making a timely election. Once the election is made, it is irrevocable.

Statements to Lessees. For lease or rental transactions to which use tax on rental receipts does not apply, the inapplicability of the tax must be indicated to lessees by a statement on the invoice that the tax does not apply for one of the following reasons:

- The property leased is a kind (specify) the lease of which is excluded from the definition of “sale” and “purchase” by Sections 6006(g) and 6010(e), respectively, of the Sales and Use Tax Law.
- The property is being leased in substantially the same form as acquired by the lessor (or transferor) and the lessor (or transferor) acquired the property in a transaction that was a retail sale with respect to which the retailer has reported and paid the sales tax, or as to which the lessor (or transferor) has paid use tax measured by the purchase price of the property.
- The property was acquired by the lessor in an exempt “occasional sale,” and the lessor has paid, or elects to pay and will pay, use tax for the period in which the property is first leased. For more information, see the “Occasional Sales” section.

THE LESSEE

Lessees of tangible personal property do not have the election of paying tax on the lessor’s purchase price or lease payments. Lessees are governed by the reporting procedure chosen by the lessor.

Is Liable for Tax. Lessees of property subject to tax on rental payments must pay the tax:

- (1) to the person from whom such property is leased only if the lessor holds a seller’s permit, or in the case of lessors located outside California, a Certificate of Registration — Use Tax.
- (2) directly to the California State Board of Equalization where the lessor does not hold such a permit or certificate.

It is important to note that lessees cannot extinguish their tax liability unless they have receipts showing payment of tax to lessors holding a seller’s permit or a Certificate of Registration — Use Tax. Regulation 1686, “Receipts for Tax Paid to Retailers,” provides that lessors who hold a seller’s permit or Certificate of Registration — Use Tax are required to issue receipts to their lessee. The required content of the receipt is explained in the regulation. The regulation may be obtained at your local Board office.

Purchase is Subject to Tax. A lease agreement granting the lessee an option to purchase the property results in a sale when the option is exercised. The tax applies to the amount required to be paid by the purchaser upon exercise of the option. The tax would apply to the sale to the lessee regardless of whether the lessor has paid tax on the cost of the equipment at the inception of the lease or on rental receipts.

WHEN RENTAL RECEIPTS ARE SUBJECT TO TAX

ITEMS SUBJECT TO TAX

The following items are generally considered to be included in rental receipts and subject to tax.

- **LICENSE, ROYALTY, REPRODUCTION RIGHTS.** If a rental or lease agreement calls for a royalty to be paid based on units produced or for use of the property, such royalties are included in rental receipts. For example: a transfer of possession, but not title, of artwork to another person for reproduction is a lease or rental of the artwork.
- **ADVANCE RENTALS.** Advance rental payments received by the lessor at the time the lease commences are subject to the tax at the time the amounts are paid by the lessee. It is immaterial that the advance rental payment is designated as applicable to the final period of the lease. Generally, if the amount collected at the commencement of a lease is designated as a “security deposit” rather than an advance rental, the amount collected would not be subject to tax until it is actually applied to a rental payment.

- **CHARGES DESIGNATED AS INTEREST.** When equipment is actually leased and not sold on credit the amounts designated by the lessor as interest, which are payable by the lessee in addition to amounts designated as rentals, are included in the rental payments subject to tax.
- **PROPERTY TAX.** When a lessee is required by the rental contract to pay for any personal property taxes assessed on the lease property, such amounts will be regarded as part of the taxable rental receipts whether the tax is assessed directly against the lessee or the lessor.
- **MANDATORY CHARGES.** When the lessee is obligated under the lease contract to use services provided by the lessor such as equipment maintenance, warranty, assembly, disassembly, etc., such additional charges are included in rental receipts. However, if the lease contract merely requires that the lessee maintain the property, the lessee's maintenance costs are not included in rental receipts.

Another example of mandatory charges is the collision damage insurance supplement offered generally by daily car rental companies. If it is required that the customer purchase the insurance as part of the rental agreement, such charges are included in rental receipts.

- **DEFICIENCY CHARGES.** These charges generally represent the difference between the actual value of the property returned to the lessor by the lessee at the termination of the lease and the value of the property prescribed in the lease contract upon which the periodic rentals were based. Such additional deficiency charges are included in rental receipts. On the other hand, credits to lessees represent a reduction in rental receipts if these adjustments are called for in the lease contract. (See the section dealing with Sale of Leased Property by Lessor.)
- **DELIVERY CHARGES.** In those circumstances where delivery of tangible personal property is made by facilities of the lessor (as distinguished from an independent contract carrier), the delivery charge is included in the measure of tax unless the transportation occurs after possession of the leased property is transferred to the lessee or after the right to possession is granted to the lessee, and the delivery charges are separately stated.

Charges for delivery made by an independent contract carrier may also be taxable where the sale is made for a delivered price.
- **RETURN TRANSPORTATION CHARGES.** Transportation charges at the termination of a lease for the return of rented property from lessees to lessors are subject to tax unless lessees have the option to provide their own return transportation. In order to be exempt, such charges must be separately stated and not be included with delivery charges.

ITEMS NOT SUBJECT TO TAX

The following items are generally considered not to be included in rental receipts subject to tax.

- **OPTIONAL CHARGES.** These are the opposite of mandatory charges discussed previously. For example, when the lessee is not obligated to use the maintenance or other service provided by the lessor, or to accept the collision damage insurance supplement offered by the daily car rental company, but chooses voluntarily to do so, the additional charges are not included in rental receipts subject to tax.
- **LATE CHARGES.** An additional payment made by a lessee for failing to pay the rental payment timely is not regarded as part of the taxable rental receipts.
- **AUTOMOBILE ANNUAL LICENSE FEES.** The annual license fees and taxes on motor vehicles are not included in rental receipts whether paid by the lessor or lessee. This differs from the treatment of property tax. The annual license fees and taxes on vehicles are specifically exempt by law from the measure of tax.

MOBILE TRANSPORTATION EQUIPMENT LEASES

Mobile transportation equipment is defined as equipment (and component parts thereof) which are used for the transportation of persons or property over substantial distances. Mobile transportation equipment includes items such as railroad cars and locomotives, trucks (including pickup trucks), truck tractors, truck trailers, buses, aircraft, ships, dollies, bogies, chassis, and reusable cargo-shipping containers. The term "ships" only includes vessels 30 feet or more in length.

Mobile transportation equipment does not include:

- Passenger vehicles (including house cars) which are designed for carrying not more than 10 persons including the driver.
- Trailers and baggage containers designed for hauling by passenger vehicles.
- One-way rental trucks discussed previously.

HOW TAX APPLIES

Lessors are considered to be consumers of the mobile transportation equipment they lease. They have the option to report their tax liability based on "fair rental value," to pay tax to the vendor, or to accrue and pay use tax timely on the purchase price of the equipment. **Fair Rental Value** normally refers to the rental payments that are required by the lease. See "Lessor Pays Tax on Fair Rental Value" on page 3 for a definition of Fair Rental Value.

If lessors elect to pay their use tax liability measured by the fair rental value of mobile transportation equipment first leased in California, the election must be made on or before the due date of the return for the period in which the equipment is first leased. When the election is made to use fair rental value as the measure of tax, the tax is due whether the equipment is in or outside California. The election is irrevocable. If the election is not made timely, the option is lost and tax must be paid on the purchase price of the equipment.

COMPONENT PARTS

Tangible personal property which is or becomes a component part of mobile transportation equipment, is included in the definition of such equipment, and sales and use tax laws and regulations apply accordingly. Examples of component parts are:

- Repair and replacement parts.
- Attached items such as cranes, air compressors, and cement mixers.
- Any item that becomes permanently affixed to mobile transportation equipment.

TAX REIMBURSEMENT

Leases of mobile transportation equipment, like rentals of motion pictures, linen supplies, etc., are not "sales" or "purchases" under the Sales and Use Tax Law. However, lessors of mobile transportation equipment who have elected timely to report their tax liability based on fair rental value are allowed to pass their use tax liability on as a separately stated item to the lessee. The separately stated tax will not be considered excess tax reimbursement and will not be included in the fair rental value. On the other hand, the treatment of excess tax reimbursement is different when a lessor of mobile transportation equipment purchases such equipment ex-tax under a resale certificate and collects tax reimbursement on the rental receipts, **but pays no tax to the State**. In this situation the lessor must pay tax on the purchase price of the equipment since a timely election to measure the tax by fair rental value was not made. However, to the extent that the tax reimbursement collected on rental receipts exceeds the tax liability measured by the purchase price, it must be returned to the lessee or paid to the State.

LEASES TO THE UNITED STATES GOVERNMENT

The application of tax to leases of mobile transportation equipment, as explained in this section, is also applicable to such leases to the United States Government. Since lessors are considered to be consumers of mobile transportation equipment they lease, there is no exemption for a sale to the United States Government.

LEASES EXEMPT FROM TAX

LEASES TO THE UNITED STATES GOVERNMENT

Tax does not apply to leases of tangible personal property (including automobiles), to the United States Government, the American National Red Cross, federal credit unions, federal reserve banks, federal home loan banks, federal land banks, federal intermediate credit banks, federal financing banks, the Federal Homeloan Mortgage Corporation, the Export-Import Bank of the United States and certain other federal instrumentalities not wholly owned by the United States and which are constitutionally exempt from state taxation. However, this exemption does not extend to leases to agents of the United States Government, United States construction contractors, national banks and leases of mobile transportation equipment to any of the aforementioned entities in this paragraph.

Tax applies to the rental of automobiles to **employees** of the United States (including military personnel) in the same manner as other rentals even though the federal employees may be traveling on government business. Rentals to federal employees are not considered rentals to the United States except in certain circumstances which require specific documentation.

If a rental agency has a General Services Administration (GSA) vehicle rental contract, automobiles rented under the contract to federal employees are regarded as having been made to the United States. Such rentals are exempt from the tax even though the federal employees may pay by cash or personal credit card.

Car rental agencies claiming as exempt from tax rentals under a GSA contract, are required to substantiate that the rental is to the United States. The substantiation should include a copy of the employee's travel orders or other appropriate documentation that will show the employee was authorized to rent an automobile under the specific GSA car rental contract. Unless there is a clear showing that the automobile is being rented pursuant to a contract between the automobile rental agency and a federal government agency, the rental is subject to tax.

LEASES TO PUBLIC AGENCIES

Previously, governmental bodies, because of budgetary restrictions, had the right to terminate contracts in the event that sufficient funds were not appropriated to pay amounts due. As such, these transactions were treated as leases rather than as sales because the governmental bodies were not considered to be bound for a fixed term.

Effective September 15, 1986, transactions with governmental bodies were to be treated as bound for a fixed term, notwithstanding any right to terminate the contract in the event that sufficient funds are not appropriated. These transactions for both mobile transportation equipment and other tangible personal property are now included in the definition of a "sale under a security agreement" (see Lease vs. Sale).

All transactions that would now be regarded as sales under a security agreement which were entered into prior to January 1, 1987 with any state or local governmental body, which had been treated as leases and had not expired, were classified as sales as of January 1, 1987.

INTERSTATE LEASES

Leases of tangible personal property designated continuing “sales” and “purchases” are not subject to California Sales and Use Tax if the property is located outside of California. If leased property is for a time located within the state and is removed to a point outside the state, tax applies only to the period of time it is situated within the state.

In the case of mobile transportation equipment, when the election is made to use fair rental value as the measure of tax, the tax is due whether the equipment is in or outside California. See the section on Mobile Transportation Equipment.

SPECIAL CATEGORIES

The following are special categories of leases which are specifically excluded from tax:

- A lease of any form of animal life the products of which ordinarily constitute food for human consumption.
- Composed type, reproduction proofs, or impressed mats leased by a typographer to another person for use in the preparation of printed matter, except when the reproduction proof is a component part of a “paste-up,” “mechanical,” or “assembly.”
- Rail freight cars used in interstate or foreign commerce.
- Mailing lists where the contract restricts the transferee or user to use the mailing list one time only.
- Aircraft leased to common carriers, foreign governments, and nonresidents of this state who will not use the aircraft in this state other than in the removal of such aircraft from this state.
- Watercraft leased for use in interstate or foreign commerce involving the transportation of persons or property for hire or for use in commercial deep-sea fishing operations outside the territorial waters of this state by persons who are regularly engaged in commercial deep-sea fishing.
- Medical oxygen delivery systems, including, but not limited to, liquid oxygen containers, high pressure cylinders, and regulators, when leased or rented to an individual for personal use as directed by a physician.

PROBLEM AREAS

PROPERTY AFFIXED TO REALTY

When certain property being leased is affixed to realty, the lessor of the property is not the lessor of the realty, and the lessor has the right to remove the property upon breach or termination of the lease contract, the affixed property remains tangible personal property. It follows that leases of such property are subject to tax. Examples include refrigeration equipment, communication systems, irrigation systems, etc.

This type of property is normally furnished under a contract to furnish and install property and the tax application is governed by Regulation 1521, Construction Contractors, a copy of which is available at any Board office. This regulation discusses three main categories of tangible personal property and their different tax applications as explained below:

- Materials means and includes construction materials and components, and other tangible personal property incorporated into, attached to, or affixed to, real property which, when combined with other tangible personal property, lose their identity and become an integral and inseparable part of the real property. (Generally speaking, construction contractors are consumers of materials, and tax applies to their cost of materials.)

- Fixtures include items which are accessory to a building or other structure and do not lose their identity as accessories when installed. (Construction contractors are retailers of fixtures, and tax applies to their cost if not separately itemized on the billing, or to the selling price of the fixtures if the price is itemized.)
- Machinery and equipment to be used in production, etc. (Construction contractors are retailers of machinery and equipment, and tax applies to the selling price.)

Construction contractors, in general, bill on a lump-sum basis and do not itemize tax on their billings. No problem exists for the lessor who does not wish to collect use tax from lessees since the tax liability, even for fixtures, is on the contractor. Under these circumstances, the lessor **does not** need an itemized billing. If a lessor of the fixtures who is not the lessor of the realty to which the fixtures will be affixed wishes to collect tax from the lessee based on rental receipts, the lessor should have the contractor itemize the price of the fixtures separately from the other items and issue a resale certificate to the contractor for the fixtures. A contractor **cannot accept a resale certificate** for materials sold and installed under a construction contract. Therefore a lessor should not collect tax from the lessee with respect to rental receipts attributable to materials.

If the lessor of realty is also leasing the fixtures, the fixtures are regarded as a component part of the realty and rental receipts are exempt from tax.

TAX PAID TO ANOTHER STATE

Generally speaking, lessors who have paid sales or use tax to another state, political subdivision of a State, or to the District of Columbia, for property they plan to lease, may take a credit against any use tax imposed by California. To qualify for the credit, the lessor **must** make a timely election to pay tax measured by the purchase price of the property and the property must be leased in substantially the same form as acquired. (See Regulation 1660(c) (8) for details.)

ASSIGNMENT OF LEASES

When a lease is assigned by a lessor (assignor) to another person (assignee), the tax status of the lease is as follows:

- If tax is being collected from the lessee it will continue to be collected from the lessee.
- If tax is not being collected from the lessee because the lease is not a continuing "sale" and "purchase," the leased property retains its tax paid status and tax should not be collected from the lessee following the assignment.

Regulation 1660, Leases of Tangible Personal Property — In General, considers three types of assignments:

- Assignment of a right and creation of a security interest.
- Assignment of the contract with transfer of right, title, and interest for security purposes.
- Assignment of the contract and all right, title, and interest.

Assignment of a Right and Creation of a Security Interest. This type of assignment is an assignment by the lessor of the right to receive the rental payments together with the creation of a security interest in the leased property. Assignees have recourse against the lessor-assignors. If lessor-assignors have been collecting tax on rental receipts, they are still liable for payment of the tax. However, assignees are obligated to remit to the Board any amounts paid to them by the lessees as tax.

There is no sale of tangible personal property between lessor-assignor and assignee.

Assignment of the Contract with Transfer of Right, Title, and Interest for Security Purposes. This type of assignment is an assignment by the lessor-assignor of the lease contract together with the transfer of the right, title, and interest in the leased property for security purposes. After the termination of the lease, the property usually reverts to the original lessor. The assignment contract may specify that the transfer is for security purposes, or the circumstances may otherwise demonstrate it (for example, a separate agreement that the property will be returned to the lessor-assignor at the termination of the lease). The assignee has recourse against the lessor-assignor.

In this situation, the assignee has assumed the position of a lessor. When tax is being collected, measured by rental receipts, the assignee is required to hold a seller's permit and is obligated to collect, report, and pay tax to the Board. The lessor-assignor should obtain a resale certificate, covering the property in question, from the assignee.

Assignment of the Contract and All Rights, Title, and Interest. This situation is similar to the assignment of the contract and all rights, title, and interest for security with these exceptions:

- The assignment is not for security purposes.
- The lessor-assignor does not retain any substantial ownership rights in the contract or property.
- The assignee has no recourse against the lessor-assignor.

In this situation, the assignee has assumed the position of the lessor-assignor. When tax is being collected, measured by rental receipts, the assignee is required to hold a seller's permit and is obligated to collect, report, and pay tax to the Board. The lessor-assignor should obtain a resale certificate, covering the property in question, from the assignee.

When Lease is not a Continuing "Sale" and "Purchase." In this situation, the assignee does not have the election to collect tax from the lessee measured by rental receipts. Generally speaking, if title to the leased property is transferred, the assignment by the lessor-assignor to the assignee is a sale and tax applies to that sale.

SUBLEASES

Two sets of circumstances which arise when property is subleased should be discussed. First, the sublessor wishes to collect use tax based on rental receipts for leases which are designated continuing "sales" and "purchases." In these situations, resale certificates may be given by the sublessor to the primary lessor and tax applies to the sublessor's rental receipts.

Second, the property is leased in substantially the same form as acquired by the prime lessor and the prime lessor has paid sales tax reimbursement or use tax measured by the purchase price. If such property is subleased, no additional tax based on rental receipts is due.

LEASES OF MOTOR VEHICLES

The general rules regarding the application of tax to leases apply to leases of vehicles. However, in order for tax to be reported based on rental receipts (or on fair rental value, in the case of mobile transportation equipment), leased vehicles must be registered as prescribed by Section 4453.5 of the California Vehicle Code in the name of either the lessor or the lessor/lessee jointly. If vehicles are registered in the name of the lessee only, tax liability may not be measured by rental receipts, and the transaction will be regarded as a retail sale subject to tax. See Regulation 1610 subsection (d) for further details and examples.

It will be presumed that a transfer of a vehicle to a lessee by a lessor, as defined in Section 372 of the Vehicle Code, was a sale for resale if the lessee transfers title and registration to a third party within 10 days from the date the lessee acquired title from the lessor at the expiration or termination of a lease. The presumption may be rebutted by evidence that the sale was not for resale prior to use. "Transfer of title and registration" occurs, for purposes of the regulation, when the lessee endorses the certificate of ownership. In this type of multiple transfer, the Department of Motor Vehicles will, at the time of registration, only collect use tax from the final purchaser and will flag all such transactions for review by the Board of Equalization.

GASOLINE FURNISHED BY THE LESSOR

A “wet rental” is a lease of a vehicle in which the rent charge includes gasoline furnished by the lessor. The lessor may or may not be required to pay sales or use tax on the purchase of the gasoline for wet rentals. Whether or not the purchase of gasoline is subject to tax will depend on the type of vehicle being leased, and on how the lessor reports and pays sales or use tax for the leased vehicle.

Vehicles that are not “Mobile Transportation Equipment.” If tax is reported based on rental receipts, the lessor can use a resale certificate to purchase, without payment of tax, gasoline that is furnished for wet rentals. Sales tax must be reported based on total rental receipts, without deduction for the gasoline.

If tax is reported based on the cost of the vehicle, the lessor is required to pay tax on the purchase of the gasoline that is furnished for wet rentals.

Mobile Transportation Equipment. Whether tax is reported based on the cost of the vehicle, or based on fair rental value, the lessor should normally pay tax on the purchase of the gasoline which will be furnished with the equipment. An exception occurs when a separate charge is made to the lessee for the gasoline. In this case, tax applies to the amount of the charge to the lessee, and the lessor may purchase the gasoline without tax by issuing a resale certificate to the supplier.

If tax is reported based on the fair rental value, and there is no separate charge for the gasoline which is furnished, tax should be reported only on that portion of the rental charge that is attributable to the lease of the equipment, not to include the value of the gasoline.

REPAIR PARTS

Sales tax does not apply to sales of repair parts to a lessor which are used in maintaining the leased equipment pursuant to a mandatory maintenance contract where the rental receipts are subject to tax. Such repair parts are regarded as being part of the sale of the leased item and may be purchased for resale.

The lessor is the consumer of repair parts used to repair equipment where an optional maintenance agreement exists. In this case, tax should be paid by the lessor to the supplier of the parts, or reported on the lessor’s sales and use tax return. If the lessor makes a separate charge to the lessee, the lessor is a retailer of the parts, and tax should be reported by the lessor on the amount of the charge for the parts.

LEASE VS. SALE

When a contract designated as a lease binds the lessee for a fixed term and the lessee is to obtain title at the end of the term upon completion of the required payments or has the option to purchase the property for a nominal amount, the contract will be regarded as a sale under a security agreement from its inception and not a lease. The option price will be regarded as nominal if it does not exceed \$100 or 1 percent of the total contract price, whichever is the lesser amount.

Sale and Leaseback Transactions. As a financing transaction, an individual may sell his or her property to a leasing company, and then lease it back from the leasing company. In general, a transaction structured as a sale and leaseback will be treated as a financing transaction rather than a lease if:

- (1) the “leaseback” transaction would be regarded as a sale under a security agreement from its inception under the above guidelines,
- (2) the purchaser-lessor does not claim any deduction, credit or exemption with respect to the property for federal or state income tax purposes, and
- (3) the amount which would be attributable to interest, had the transaction been structured originally as a financing agreement, is not usurious under California law.

SALE OF LEASED PROPERTY BY LESSOR

Sale of leased property by the lessor is subject to sales or use tax in the same manner as sales generally. The election chosen by the lessor at the commencement of the lease does not alter the tax application to sales of leased property by lessors. Where the lease agreement provides the lessee with an option to purchase the leased property, a sale occurs and tax is due based on that sale at the time the option is exercised.

COLLECTING & REPORTING TAX

NEED FOR A PERMIT

Every person engaged in the business of selling (or leasing under a lease defined as a continuing “sale” and “purchase”) tangible personal property of a kind the gross receipts from the retail sale of which are required to be included in the measure of the sales tax, and only a person actively so engaged, is required to hold a permit for each place of business in this state at which transactions relating to sales are customarily negotiated with customers.

TOTAL SALES

A lessor is required to report the lease receipts paid by the lessee during the reporting period. These lease receipts should properly be reported on Line 1 of the lessor's sales and use tax return. Additionally, the lessor should report on Line 1 the gross receipts from all sales of tangible personal property.

For property that is not mobile transportation equipment: Any rental receipts which are due but have not been paid to the lessor by the lessee are not considered gross receipts of the lessor. For sales and use tax purposes, rental receipts should be reported by the lessor only after payment has been received.

For mobile transportation equipment: A lessor is required to report the fair rental value for all periods during which the mobile transportation equipment is leased even though the lessee might not have made the rental payments.

SELF CONSUMED MERCHANDISE

Self-consumed merchandise is to be reported on Line 2 of the sales and use tax return. If a lessor purchases property without tax and chooses to pay tax on the cost rather than the rental receipts, the purchase should be reported on Line 2 in the period during which the property is first placed in rental service. Other items to be reported on Line 2 may include repair parts and gasoline if the lessor is the consumer and they have been purchased without sales and use tax. (The section titled, “REPAIR PARTS” explains when a lessor is considered the consumer.)

A lessee is to report on Line 2 the rentals payable in the reporting period in which no tax was collected by the lessor and the lessee does not have a statement from the lessor which would allow the lessee to regard the lease receipts as exempt.

If a lessor makes use, other than leasing or demonstration and display, of property for which tax has been paid based on rental receipts, the cost of the property is to be reported on Line 2. In such case, any rental receipts for which tax has been previously reported could be offset against the cost. Should the rental receipts exceed the cost, no refund of the excess is allowed and no additional tax would be due on the cost. Subsequent rental receipts remain taxable, but if tax measured by cost exceeded tax measured by prior rentals, the excess may be used as an offset against an equal amount of tax on subsequent rentals.

DEDUCTIONS

Deductions should be claimed only for exempt amounts included on Line 1 of the tax returns. Taxpayers should claim deductions for those rental receipts received from exempt leases which are not continuing "sales" and "purchases." For leases exempt from tax, see "LEASES EXEMPT FROM TAX."

Any resales supported by valid resale certificates should be claimed. This would include sales of equipment as well as subleases where the sublessor has issued a resale certificate and has elected to report tax on rental receipts.

Other deductions which should be claimed include optional charges such as insurance where the lessee is not obligated to use the service provided by the lessor, repair labor on optional maintenance contracts, separately stated installation labor, late charges, and automobile annual license fees.

For non mobile transportation equipment: If lessors have reported under the accrual method they are entitled to a deduction for rental receipts reported that have not been paid by the lessees. This is not a bad debt deduction because the lessors are not obligated to report the rental receipts until payments are received.

TAX REIMBURSEMENT

Use Tax. In the case of a lease that is a continuing "sale" and "purchase," the tax is measured by the rental receipts. Generally, the applicable tax is a use tax upon the use of the property in this state by the lessee. The lessor must collect the tax from the lessee at the time rentals are paid by the lessee and give a receipt as stated in Regulation 1686. The lessee is not relieved from liability for the tax until the lessee is given such a receipt or the tax is paid to the state. See also "Tax Reimbursement on Leases of Mobile Transportation Equipment."

Sales Tax. When the lessee is not subject to use tax, the sales tax applies. The sales tax is upon the lessor and is measured by the rental receipts. Although the lessor is liable for sales tax on such rentals, the Civil Code provides that the question of tax reimbursement is a matter of agreement between the retailer (lessor) and the purchaser (lessee).

Excess Tax Reimbursement. Excess tax reimbursement would be collected in the following transaction. A lessor purchases property and pays sales tax or use tax reimbursement on the purchase to the vendor. The property is leased in the same form as acquired and either sales tax or use tax reimbursement is collected on the rental receipts. To the extent that the tax reimbursement collected on rental receipts exceeds the tax reimbursement paid on the purchase price, it must be returned to the customer or paid to the State in accordance with Section 6901.5 and Regulation 1700. The law applies in this manner whether the property is leased to a single lessee or a series of lessees.

LOCAL SALES AND USE TAX AND DISTRICT TAXES

With certain exceptions, all of the provisions of the State Sales and Use Tax Law and regulations adopted thereunder are applicable to state-administered local sales and use taxes and to state-administered transactions (sales) and use taxes imposed by special taxing districts. Local taxes are effective statewide while district taxes are effective only in areas that have enacted district tax ordinances. The overall tax rate is a combination of state and local sales and use taxes and where enacted, district taxes. Regulation 1821 contains general information on district taxes.

Allocation of the One Percent Local Tax.

- Sales tax on retail sales: If a retailer has only one place of business in this state, all California retail sales occur at that place of business and the one percent state-administered local sales tax should be allocated to that place of business. If a retailer has more than one place of business in this state which participates in the sale, the transaction occurs at the place of business where the principal negotiations are carried on and the one percent local tax should be allocated accordingly. It is immaterial that title or possession

of the property passes at a place outside the local taxing jurisdiction of the retailer or that the property is never within the taxing jurisdiction of the retailer.

- **Use tax on leases:** The tax imposed on a lease is the use tax. If the lessor elects to report tax based on rental receipts, the one percent state-administered use tax collected by the lessor must be allocated to the county where the property is being used by the lessee.

Collection of District Tax. Retailers deriving taxable rentals from a lease of tangible personal property which is situated in a special taxing district must collect the district tax of each such district in which such property is leased or rented. The district tax should be allocated to the district in which the leased property is situated.

In the case of mobile transportation equipment leased by a lessor who has elected to pay tax liability measured by the fair rental value of such equipment, the place of first use determines the application of the district tax. If the place at which the equipment is withdrawn from the lessor's resale inventory for rental use is in a district imposing a district tax, the tax of that district must thereafter be paid for each reporting period, measured by the fair rental value, whether the equipment is within or out of this state. The district tax should be allocated accordingly.

Further information on district taxes is contained in Pamphlet No. 44, District Taxes, copies of which can be obtained from any office of the State Board of Equalization.

KEEPING RECORDS

What Records Must be Kept. You are required by the Sales and Use Tax Law to keep adequate records showing:

- Your gross receipts from sales or leases of tangible personal property, whether you regard the receipts as taxable or nontaxable.
- All deductions allowed by law and claimed in filing returns.
- The total purchase price of all tangible personal property purchased for sale, consumption, or lease.

These records must include:

- The normal books of account.
- All bills, receipts, invoices, contracts, or other documents of original entry supporting the entries in the books of account.
- All schedules or working papers used in connection with the preparation of tax returns.

Failure to maintain accurate records will be considered evidence of negligence or intent to evade the tax, and may result in penalties.

Keep Sales and Use Tax Records Four Years unless the Board of Equalization authorizes in writing their earlier destruction. This applies to all records pertaining to transactions involving sales or use tax liability. Invoices or other documentation supporting the timely payment of tax on the purchase price of leased property should be retained until the property is no longer in rental service.

Representatives of the Board of Equalization may examine your books, papers, records, and other documents to verify the accuracy of any return made, or if no return is made, to determine the amount of tax you must pay.

FOR MORE INFORMATION

For more information you may:

- Contact your local Board office and talk to a representative about how to apply the law or complete a form.
- Request copies of the laws and regulations that apply to your business.
- Write for advice regarding the taxability of a particular sale or transaction. Written requests should be sent to your local Board office or to the Board's headquarters offices. They should fully describe the facts and circumstances of the transaction. *Note:* If you rely on a written response from the Board regarding the taxability of a particular sale or transaction, you may be relieved of any tax, penalty, or interest related to that transaction if the Board determines that its written response included errors.
- Enroll in a basic sales and use tax class offered by some local Board offices. You should call ahead to find out whether your local office conducts a class for beginning sellers.

REGULATIONS

1521	<i>Construction Contractors</i>
1660	<i>Leases of Tangible Personal Property — in General</i>
1661	<i>Leases of Mobile Transportation Equipment</i>
1686	<i>Receipts for Tax Paid to Retailers</i>
1698	<i>Records</i>
1700	<i>Reimbursement for Sales Tax</i>
1821	<i>Foreword — District Taxes</i>

A complete listing of Board regulations appears in Pamphlet 73, *Your California Seller's Permit*.

PUBLICATIONS

Publications that may be of interest include the following pamphlets:

9	<i>Construction and Building Contractors</i>
34	<i>Motor Vehicle Dealers</i>
44	<i>District Taxes</i>
61	<i>Sales and Use Taxes: Exemptions and Exclusions</i>
70	<i>The California Taxpayers' Bill of Rights</i>
73	<i>Your California Seller's Permit</i>
74	<i>Closing Out Your Seller's Permit</i>
75	<i>Interest and Penalty Payments</i>
76	<i>Audits and Appeals</i>
77	<i>Publications</i>

As a registered seller, you also receive the *Tax Information Bulletin*, which includes articles on the application of law to specific types of transactions, announcements regarding new and revised publications, and other articles of interest to registered sellers.

Copies of publications and regulations may be obtained through a local Board office. See page 16 for telephone numbers. It is recommended that you call ahead and ask whether the publication you need is in stock.

Publications may also be ordered in writing from:

Supply Unit
State Board of Equalization
3920 West Capitol Avenue, Suite 200
West Sacramento, CA 95691

FIELD OFFICES

Staff located in the Board of Equalization field offices listed below will be glad to answer your questions regarding the taxes administered by the Board. If you already have a seller's permit and are calling regarding your account, you will receive quicker assistance if you have the number of your permit available when you call.

CITY	AREA CODE	NUMBER	CITY	AREA CODE	NUMBER
Arcadia	818	350-6401	Salinas	408	443-3008
(from LA)	213	681-6675	San Bernardino	909	383-4701
Arroyo Grande	805	489-6293	San Diego	619	525-4526
Auburn	916	885-8408	San Francisco	415	396-9800
Bakersfield	805	395-2880	San Jose	408	277-1231
Bishop	619	872-3701	San Marcos	619	744-1330
Chico	916	895-5322	San Mateo	415	573-3800
Concord	510	687-6962	San Rafael	415	472-1513
Covina	818	331-6401	Santa Ana	714	558-4059
Crescent City	707	464-2321	Santa Barbara	805	564-7731
Culver City	310	313-7111	Santa Cruz	408	462-9496
(from LA)	213	879-0600	Santa Rosa	707	576-2100
Downey	310	803-3471	Sonora	209	532-6979
(from LA)	213	773-3480	South Lake Tahoe	916	544-4816
El Centro	619	352-3431	Stockton	209	948-7720
Eureka	707	445-6500	Susanville	916	257-3429
Fresno	209	445-5285	Torrance	310	516-4300
Grass Valley	916	272-1347	(from LA)	213	770-4148
Hollywood	213	913-7800	Ukiah	707	463-4731
Laguna Hills	714	770-2157	Union City	510	429-7090
Lakewood	310	421-3295	Vallejo	707	648-4065
(from LA)	213	636-2466	Van Nuys	818	901-5293
Lancaster	805	940-7383	Ventura	805	654-4523
Marysville	916	741-4301	Visalia	209	732-5641
Merced	209	726-6527	Yreka	916	842-7439
Modesto	209	576-6360			
Oakland	510	286-0347			
Placerville	916	622-1101			
Quincy	916	283-1070			
Rancho Mirage	619	346-8096			
Redding	916	224-4729			
Riverside	909	782-4330			
Sacramento	916	255-3350			

OFFICES FOR OUT-OF-STATE ACCOUNTS		
CITY	AREA CODE	NUMBER
Chicago, IL	312	201-5300
Houston, TX	713	681-1106
New York, NY	212	697-4680
Sacramento, CA	916	322-2010

TAXPAYERS' RIGHTS ADVOCATE

The State Board of Equalization has appointed a Taxpayers' Rights Advocate to help you with problems you cannot resolve at your local Board office. You may contact the Taxpayers' Rights Advocate by writing to the State Board of Equalization, P.O. Box 942879, Sacramento, CA 94279-0001; or by telephoning 916-324-2798.

APPENDIX: QUESTIONS AND ANSWERS

1. Our company has attempted to purchase all leased equipment tax paid (**not** mobile transportation equipment). We have found that several pieces of equipment currently being leased were purchased without tax and we inadvertently neglected to report the purchase price and pay use tax in the period the equipment was placed in rental service.

Can we now make a retroactive adjustment and pay tax on the cost of the equipment or must we collect and report tax on rental receipts?

*A. The election to pay tax on the cost of the equipment and payment of that tax must be made timely. A timely election means that the election **must** be made in the quarterly period in which the leased equipment first enters lease service. The tax due for that period must be paid timely. Because no timely election was made to pay tax on the cost of the equipment, you are required to collect and report tax on rental receipts.*

2. Our company has been assigned a lease by a lessor (assignor). Is the tax status of the lease affected and who is responsible for collecting the tax?

A. The tax status of the lease is not affected. If tax is being collected from the lessee it will continue to be collected from the lessee. If the lease was excluded from the definition of a "sale" or "purchase," it will continue to be excluded.

The party who is responsible for collecting the tax depends on the type of assignment made. When the assignment of an existing lease which is on a rental receipt basis occurs and the assignment includes the transfer of title, the assignee has assumed the position of the lessor and is required to collect the tax. If no transfer of title takes place, the original lessor (assignor) is still liable for the collection and payment of tax. However, the assignee is obligated to remit to the Board any amounts of tax paid to him/her by the lessee.

When an existing lease which is not a "sale" and "purchase" is assigned, the rental payments are not subject to tax whether or not the assignment includes transfer of title. If title is transferred, tax applies measured by the sales price.

3. We acquired some material and paid sales tax on the purchase price to the vendor. Subsequently, an outside party fabricated it into equipment and charged us sales tax on the fabrication labor. We are now leasing the equipment. Does tax apply?

A. No. If tax has been paid by a lessor on the full purchase price of the property consisting of the cost of materials and outside fabrication labor, no tax is due on the rental receipts from the leasing of the property.

If the material had been fabricated using inside labor, the property would not be considered leased in substantially the same form as acquired and tax would apply to the rental receipts. A tax-paid-purchase-resold credit would be allowed on the tax-paid material.

4. We have had property in lease service outside of California for less than ninety (90) days. The lessee is now bringing the property to their plant in California. What is our tax liability?

A. Use tax is to be reported based on the lessor's purchase price or measured by rental receipts. Under these circumstances, the law presumes the equipment was purchased for use in California.

Note: *If the property was in lease service outside of California for **more** than 90 days, use tax measured by rental receipts must be reported — the option to report use tax based on the lessor's purchase price would no longer be available.*

5. Would the answer above be different if the property was mobile transportation equipment?

A. No. The equipment will be presumed to be purchased for use in California. However, the lessor's use tax liability would be due on the cost of the mobile transportation equipment, unless the lessor makes a timely election to report use tax measured by the fair rental value. Under current law, both dealers and nondealers of mobile transportation equipment may elect to pay their use tax liability measured by cost or fair rental value.

Note: *If the property was in lease service outside of California for **more** than 90 days, and was not purchased for use in California, no additional tax would be due on cost or rentals.*

6. A lessee takes possession of mobile transportation equipment outside of California and enters California with a load picked up out-of-state. Subsequently, the lessee uses the equipment exclusively in interstate commerce but not exclusively in California. Does the lessor or lessee have a California tax liability?

A. No. The equipment is first used functionally outside the state and is used continuously thereafter in interstate commerce and not exclusively in California. No tax applies.

7. Our company is a dealer in mobile transportation equipment. Can we accept a resale certificate from a lessor who is not also a retailer of mobile transportation equipment?

A. Yes. Under current law, any lessor of mobile transportation equipment has the option of paying tax based on the purchase price of the equipment or its fair rental value.

8. If our company is leasing mobile transportation equipment and paying use tax based on fair rental value, can we separately state and collect this use tax from our lessee?

A. Yes. Under current law, the lessor of mobile transportation equipment is allowed to exclude the use tax element from fair rental value. On the other hand, lump-sum charges to the lessee will be assumed to include reimbursement for the lessor's use tax whether or not any statement to that effect is made to the lessee.

9. Our company is currently leasing mobile transportation equipment. The equipment was purchased for resale and we report use tax based on its fair rental value. Does sales tax apply to repair parts purchased for this equipment from our California supplier?

A. No. A lessor who has properly elected to measure use tax by "fair rental value" may properly purchase repair parts placed on such equipment ex-tax by issuing a resale certificate.

10. Our company is located outside of California and leases property to California lessees. The property will be situated in California. What is our obligation?

A. As you are deriving rentals from a lease of tangible personal property situated in this state, the provisions of the California Sales and Use Tax Law apply to your company. Out-of-state lessors should contact the nearest office of the Out-of-State District listed on page 16 for assistance or to obtain a seller's permit.